

## CALIFORNIA FRANCHISE TAX BOARD

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Water's Edge Manual

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### Chapter 20A      Record Maintenance -- Information Reporting Requirements

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### ***References:***

R&TC §19141.2  
R&TC §19141.5(a)  
R&TC §21015  
IRC §6038  
IRC §6038A  
Treasury Regulations §1.6038 and §1.6038A

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### ***Training Objectives:***

One of the biggest challenges facing auditors is obtaining access to the taxpayer's relevant business records. The IRS considered this to be a significant problem in the effective enforcement of IRC §482. To help reduce or eliminate this problem, §6038A was enacted and §6038 was modified. This section of the Water's-Edge Manual provides an analysis of the federal rules and regulations (which California has conformed to) that require corporations to file Forms 5471 and 5472 and maintain certain records needed for audit purposes.

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### **a. Background**

IRC §6038A was added and IRC§6038 was modified in 1982 as part of TEFRA. Prior to the enactment of TEFRA, United States citizens or residents who were officers or directors of a foreign personal holding company were required to file several information returns. TEFRA consolidated the foreign personal holding company reporting requirements and required the filing of form 5471 by certain officers, directors and United States shareholders to eliminate unintended loopholes. In addition, IRC§6038A was added to the code in order to place foreign-controlled domestic companies on par with domestic companies controlled by U.S. shareholders. This section requires foreign-controlled companies doing business in the U.S. to report the same kind of information on related-party transactions as U.S. companies were required to report on controlled foreign corporations under IRC §6038. It also requires such corporations to maintain certain records needed for §482 audit purposes. The Revenue Reconciliation Act of 1989 substantially amended IRC §6038A and it was amended again in 1990. The Taxpayer Relief Act of 1997 amended IRC§6038 to extend the requirement of filing information returns to United States person or partners who control foreign partnerships.

R&TC §19141.5(a), formerly §25940, conformed California law to IRC §6038A operative for income years beginning on or after January 1, 1990 with minor modifications relating to enforcement of requests for certain documents.

R&TC §19141.2 was added to California Law to conform to IRC§6038 in a modified form. The law is operative for returns required to be filed on or after January 1, 1997. However, the penalty imposed for noncompliance does not apply to income years beginning before January 1, 1998.

**IMPORTANT:** California's conformity to IRC §6038 and §6038A applies to taxpayers filing on **EITHER** a water's-edge or worldwide combined report basis.

IRC §6038A and IRC §6038 address the following:

1. Requirement to file federal Forms 5471 and 5472 (for foreign corporations) or Form 8865 (for foreign partnerships)
2. Record Maintenance
3. Monetary Penalty for failure to furnish information or maintain records

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4. Authorization of Agent
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### **b. Rules And Definitions**

#### **1. IRC §6038 In General**

IRC §6038 requires that a *United States person* file an information return with respect to any *foreign business entity* that it *controlled* during the year. If the foreign business entity is a controlled foreign corporation (CFC), each U.S. shareholder of the CFC may be required to file the information return even though the shareholder holds less than a controlling interest (see Chapter 9, Water's-Edge Manual, for definitions of CFC and U.S. shareholder). The return is filed on Form 5471 for foreign corporations or Form 8865 for foreign partnerships.

- A. **United States Person** The term "United States person" generally means a US citizen or resident, a domestic corporation or partnership, or an estate or trust. IRC §7701(a) defines a corporation to be an association, a joint-stock company, and an insurance company, and applies the term domestic to a corporation created or organized in the United States or under the law of the United States or of any State. California law modifies the definition of a United States person. For state purposes, the definition of a United States person is limited to a domestic corporation as defined in Section 7701 (a) of the Internal Revenue Service, or a bank as defined in R&TC §23039. Furthermore, California law limits the filing requirement to domestic corporations or banks that are subject to the California franchise tax, income tax or the alternative minimum tax.
- B. **Foreign Business Entity** The term "foreign business entity" means a foreign corporation or a foreign partnership.
- C. **Control in the case of a foreign corporation**, the US person is considered in control if it owns (directly or indirectly, or constructively within the meaning of section 958(a) and (b)), more than 50% of:
  - 1. The total combined voting power of all classes of the foreign corporation's voting stock; or
  - 2. The total value of stock of the foreign corporation.

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Chain corporation ownership and attribution rules of IRC §318(a) (with exceptions) determine stock ownership. See Treas. Reg. §1.6038-2(b) and (c). The US person must control the foreign corporation for an uninterrupted period of at least 30 days during the foreign corporation's annual accounting period. If the US person controls the foreign corporation for less than 30 consecutive days, there is no 5471 filing requirement with respect to that foreign corporation. If a US person is in control of an upper tier corporation that, in turn, is in control of lower tier corporation, the US person is also treated as being in control of the lower tier corporation. Example:

Corporation A owns 51% of the voting stock in Corporation B, Corporation B owns 51% of voting stock in Corporation C, C owns 51% of the voting stock in Corporation D. Therefore, Corporation D is controlled by A.

**In the case of a foreign partnership**, the term "control" means that a US person owns directly or indirectly more than a 50% interest in the partnership. The more than 50% interest may be either a capital interest, an interest in the partnership profits, or (to the extent provided by regulation) an interest in the deductions or losses of the partnership. If US persons (that each have at least a 10% interest) control a foreign partnership, but no single US person controls more than 50%, then each 10% US partner may be required to furnish certain information about the partnership. (Proposed Regulation §1.6038)

## 2. IRC §6038a In General

IRC §6038A (a) and (b) require a *reporting corporation* to file a 5472 for each *related party* that it has a *reportable transaction* with and to maintain certain records so that IRS/FTB auditors can determine if arms-length prices are being charged for intercompany transactions.

### A. Reporting Corporation

A "reporting corporation" is either:

- a domestic corporation that is 25% foreign-owned<sup>1</sup> or
- a foreign corporation engaged in a trade or business within the U.S. at any time during a taxable year. (Prior to 1/1/89, the foreign corporation was required to be 25% foreign-owned.)<sup>2</sup>

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There are two exceptions to these definitions. Treaty country residents having no permanent establishment in the U.S. are not reporting corporations nor are foreign corporations whose gross income is exempt under IRC §883 (qualified exempt shipping and aircraft income).<sup>3</sup>

### **B. Related Party**

A related party means

- any 25% foreign shareholder (direct or indirect) of the reporting corporation,
- any person who is related (per §267(b) or 707(b)(1)) to the reporting corporation or a 25% foreign shareholder, or
- any other person who is related (within the meaning of §482) to the reporting corporation.<sup>4</sup>

### **C. 25% Foreign Owned**

A reporting corporation is 25% foreign owned if at least 25% of

- the total voting power of all classes of stock of the reporting corporation entitled to vote, or
- the total value of all classes of stock of the reporting corporation, is owned (directly or indirectly) at any time during the year by 1 foreign person.<sup>5</sup> Attribution rules of IRC §318 are used to determine indirect ownership.<sup>6</sup> A foreign person can be an individual, a corporation, or a partnership.<sup>7</sup>

### **D. Reportable Transactions**

Reportable transactions (involving monetary consideration) include the following:<sup>8</sup>

- sales and purchases of inventory and other tangible assets,
- transactions involving intangible assets,
- rents and royalties,
- consideration paid or received for services rendered,
- amounts loaned or interest paid or received,
- insurance premiums or payments, and
- commissions and other amounts not previously specified.

Information must also be reported for transactions involving nonmonetary consideration or consideration of less than fair market value. See Treas. Reg. §1.6038A-2(b)(4) for more information.



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### **c. Federal Forms 5471 & 5472**

#### **1. Federal Form 5471**

The return must contain the information required by IRC §6038(a)(1) and Treas. Reg. §1.6038-2(f) and (g). Some of the information required to be included in the 5471 includes the following:

1. Name, address, and employer identification number, if any of the foreign corporation,
2. The name, address and identifying number of any branch office or agent of the foreign corporation located in the United States,
3. The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation, and the location of such books and records if different from such address,
4. The nature of the corporation's business and the principal places where conducted,
5. A description of each class of the corporation's stock, and the number of shares of each class outstanding at the beginning and end of the annual accounting period,
6. Identification of each United States person owning 5 percent or more in value of any class of the corporation's outstanding stock during the year,
7. For the annual accounting period, the amount of the corporation's current earnings and profits, foreign taxes paid or accrued, distributions, and E&P information including post-1986 undistributed earnings described in section 902(c)(1), pre-1987 amounts, total earnings and profits, and previously taxed earnings and profits described in section 959 (c), and
8. A summary showing the total amount of each of the following types of transaction of the corporation, which took place during the annual accounting period, with the person required to file the return, any other corporation controlled by that person, or any United States person owning at the time of the transaction 10 percent or more in value of any corporation controlling that foreign corporation,
  - Sales and purchases of stock in trade,
  - Purchases of tangible property other than stock in trade,

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- Sales and purchases of patents, inventions, models, or designs (whether or not patented), copyrights, trademarks, secret formulas or processes, or any other similar property, rights,
  - Compensation paid and compensation received for the rendition of technical, managerial, engineering, construction, scientific, or like services,
  - Commission paid and commissions received,
  - Rents and royalties paid and rents and royalties received,
  - Amount loaned and amounts borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph that arise and are collected in full in the ordinary course of business),
  - Dividends paid and dividends received,
  - Interest paid and interest received, and
  - Premiums received for insurance or reinsurance.

The following forms with respect to foreign corporations are to be attached to the returns filed.

1. A statement of the corporation's profit and loss for the annual accounting period
2. A balance sheet as of the end of the annual accounting period of the corporation
3. An analysis of changes in the corporation's surplus accounts during the annual accounting period including both opening and closing balances.

For returns filed after December 31, 1995 and tax years ending after December 31, 1994, amounts furnished under Treas. Reg. §1.6038-2(g) must be in United States dollars computed and translated in conformity with United States generally accepted accounting principles. Earnings and profits furnished under Treas. Reg. §1.6038-2(f) (10) is to be expressed in the foreign corporation's functional currency except to the extent the form requires specific items to be translated into United states dollars. With respect to Treas. Reg. §1.6038-2(f) (11), the amounts must be expressed in United States dollars translated from functional currency at the weighted average exchange rate for the year as defined in §1.989(b)-1. See Treas. Reg. §1.6038-2(h).

See Treas. Reg. §1.6038-2 and the Form 5471 for more information about the information required to be reported.

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### **2. Federal Form 5472**

A "reporting corporation" must file a separate Form 5472 for each related party with whom the reporting corporation has a reportable transaction.<sup>9</sup>

The information required to be included in the 5472 includes the following:

- Name of the related party,
- Principal place of business of the related party,
- Nature of business of the related party,
- Manner in which the reporting corporation is related to each related party,
- Transactions between the reporting corporation and each foreign person related to the reporting corporation.

See Treas. Reg §1.6038A-2 and the Form 5472 for more information about the information required to be reported.

**Reasonable estimates** - Any amount reported on Form 5472 is considered to be a reasonable estimate if it is at least 75% and not more than 125% of the actual amount.<sup>10</sup> Any estimates made outside these parameters would require the reporting corporation to provide a written statement to the IRS showing the relevant facts and circumstances.

**Small Amounts** - If any actual amount required to be reported on Form 5472 does not exceed \$50,000, the amount may be reported as "\$50,000 or less."<sup>11</sup>

### **3. Exceptions For Filing Forms 5471 & 5472**

#### **A. Form 5471**

No returns are needed for a corporation defined in Code Section 1504(d) relating to subsidiaries formed to comply with foreign law which files a consolidated return for the taxable year (so-called "contiguous country corporations"). See Treas. Reg. §1.6038-2(a).

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In addition, the Internal Revenue Service allows dormant foreign corporation to file under a summary filing procedure, instead of the complete Form 5471. See Rev. Proc. 92-70, 1992-2 CB 435. The summary return is actually page one of Form 5471. The summary return must include the filer's name and address, identifying number, filing category, stock ownership percentage, and tax year. And it must contain the dormant foreign corporation's annual accounting period, name, address, employer identification number (if any), and the country and date of incorporation. A dormant foreign corporation is defined as one that at all times during its annual accounting period met the following conditions:

- (1). it conducted no business and owned no stock in any other corporation other than another dormant foreign corporation
- (2). none of its shares (other than directors' qualifying shares) were sold or other wise transferred, and the corporation was not a party to a reorganization
- (3). none of the corporation's assets were sold or transferred, except for certain de minimis transfers (up to \$5,000 of expenses or gross income or receipts)
- (4). the value of the corporation's assets did not exceed \$1,000,000
- (5). the corporation did not make any distributions and
- (6). the corporation either had no current or accumulated earnings and profits, or had only de minimis changes in its beginning and ending E&P balances because of de minimis income or expenses.

### ***B. Form 5472***

Form 5472 is not required if:

- the reporting corporation has no reportable transactions with any related party;<sup>12</sup>
- the related party is a Controlled Foreign Corporation and the U.S. shareholder is filing a federal Form 5471;<sup>13</sup> or
- the foreign related party is a FSC.<sup>14</sup>

## ***4. California Filing Requirements***

The California filing requirement is met by attaching copies of the 5471s and 5472s to the California return. If the federal Form 5472 is filed on a consolidated basis, the California taxpayer must attach any consolidated Forms 5472 that it joined in filing to the California return. Because the California filing requirement

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is only imposed on taxpayers, only copies of federal 5471s or 5472s filed by the *taxpayer(s)* must be attached to the California return. Forms 5471 or 5472 filed by *nontaxpayer affiliates* are not required to be attached to the return (even if filed by a unitary affiliate of the taxpayer).

**NOTE:** For federal purposes, when a consolidated return is filed, the reporting corporations can consolidate their transactions with each related party and thus file only one 5472 for each related party.<sup>15</sup> The consolidated 5472 must include a schedule to identify which reporting corporations have reportable transactions with the related party. If one of those reporting corporations is a California taxpayer, that taxpayer is required to attach a 5472 to the California return.

If two or more persons meet the Form 5471 filing requirement for the same foreign corporation, such persons may file a joint 5471 in lieu of separate 5471s. The joint 5471 must be filed with the tax return of any one of the persons making the joint return. See §6038(d) and Treas. Reg. §1.6038(j)(1).

### **5. Forms 5471 & 5472 Due Date**

For federal purposes, all Forms 5471 and 5472 are required to be filed by the due date or extended due date of the return whether or not the return is actually filed at that time.<sup>16</sup> California conformed to §6038 and 6038A, therefore, a COPY of the federal Forms 5471 and 5472 is due by the due date or extended due date of the California return.

If the tax return is filed late, Form 5472 must nonetheless be filed by the return due date (including extensions). A copy of the Form 5472 must also be attached to the late-filed tax return.

The Internal Revenue Service may grant reasonable extensions of time for the filing of Forms 5471. See Treas. Reg. §1.6038-2(i).

### **6. Effective Dates And Amnesty For Late Filing**

#### **A. Form 5471**

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The federal requirement to file Form 5471 was effective for years ending on or after December 31, 1983. With regard to the annual information return for a foreign partnership, the Form 8865 is generally required for partnership annual accounting periods ending on or after 12/31/2000, but see the instructions to the Federal Form 8865 for additional effective date information.

California did not conform to the federal filing requirement until income years beginning on or after January 1, 1997. However, the penalty may not be imposed for years beginning before January 1, 1998.

### ***B. Form 5472***

The requirement to file Form 5472 is generally effective for taxable years beginning on or after January 1, 1983 for federal purposes. For California, the requirement to file Form 5472 is effective for taxable years beginning on or after January 1, 1990.

The requirement to file Form 5472 for corporations whose sole trade or business in the U.S. is banking, financing, or a similar business is effective for taxable years beginning after December 10, 1990 for both California and federal tax purposes.<sup>17</sup>

When R&TC §25940(a) was enacted it was overlooked by a substantial number of taxpayers and their accounting firms, resulting in the failure to file timely Form 5472s with their California returns for income years beginning on or after January 1, 1990.

FTB Notice 92-1 was issued to allow an amnesty period. For federal Forms 5472 due prior to February 18, 1992, the notice allowed taxpayers until June 15, 1992, to file amended returns and include copies of all federal Forms 5472 without penalty. Any Federal Forms 5472 filed late after the amnesty period are potentially subject to the \$10,000 penalty per form. (See part 5 of Chapter 20A(g), Water's-Edge Manual.)

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### ***d. Record Maintenance Requirement<sup>18</sup>***

A reporting corporation must keep the permanent books of account and records that are sufficient to establish the correctness of its state/federal tax return. It must also maintain information, documents, or records, to the extent they may be directly or indirectly relevant, to determine the correct tax treatment of transactions with related parties.

Such records must be permanent, accurate, and complete, and must clearly establish income, deductions, and credits. Additionally, in appropriate cases, such records include sufficient relevant cost data from which a profit and loss statement may be prepared for products or services transferred between a reporting corporation and its foreign related parties. This requirement includes records of any foreign related party that may be relevant to determine the correct U.S. tax treatment of transactions between the reporting corporation and foreign related parties. The relevance of such records with respect to related party transactions shall be determined on a facts and circumstances basis.<sup>19</sup>

The purpose of the record maintenance requirement is generally to require taxpayers to maintain the records needed to conduct a Section 482 transfer pricing audit. Much of the information may also be useful for making a unitary determination. If the records are in the control of a foreign related person, the records may be obtained or compiled under the direction of the reporting corporation and then maintained by the reporting corporation, the foreign related person, or a third party.

These records maintenance provisions do not apply to small corporations that have less than \$10 million in U.S. gross receipts for a taxable year. (These corporations also do not have to be an authorized agent of the foreign parent per Treas. Reg. §1.6038A-5.<sup>20</sup> See Chapter 20A(h), Water's-Edge Manual for a discussion of the requirement that the reporting corporation act as agent for the foreign related person.)

When records are provided to the IRS/FTB (which are in a foreign language) under a request for production, they must be translated into English within 30 days of a request for translation. Appropriate extensions will be liberally granted for translation requests where circumstances warrant. If a good faith effort is made to translate accurately the requested documents within the specified time

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period, the reporting corporation will not be subject to the monetary penalties or the noncompliance penalty.<sup>21</sup> (See Chapter 20A(g), Water's-Edge Manual for a discussion of these penalties.)

In order to provide certainty as to what records will satisfy the requirements of §6038A, the regulations provide a "safe harbor" record maintenance provision.

The requirement to maintain records (for California and federal tax purposes) is generally effective December 10, 1990.<sup>22</sup> However, records in existence on or after March 20, 1990, must be maintained, without regard to when the taxable year to which the records relate began. This requirement includes records maintained in a foreign country.<sup>23</sup>



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### e. ***Safe Harbor***<sup>24</sup>

If the safe harbor record maintenance rules are met, the taxpayer will be deemed to have met the requirements of §6038A. The safe harbor consists of a list of record types that could be relevant to different taxpayers under a variety of facts and circumstances. It does not constitute a checklist of records that every reporting corporation must maintain or that generally should be requested by the IRS/FTB.

Even though records are enumerated in the safe harbor, a reporting corporation is only required to maintain, and the IRS/FTB will only request, those records that may be relevant to its business or industry and to the correct U.S. tax treatment of its transactions with its foreign related-parties.

#### ***1. Specific Records To Be Maintained For Safe Harbor***<sup>25</sup>

The regulations provide general descriptions of the categories of records to be maintained; the particular title or label applied by a reporting corporation or related party does not control.

Record maintenance requires only the maintenance of types of documents that are directly or indirectly related to transactions between the reporting corporation and any foreign related party.

Record maintenance generally does not require the original creation of records that are ordinarily not created by the reporting corporation or its related parties. There are two exceptions to this rule.

- Basic accounting records that are sufficient to document the U.S. tax effects of transactions between related parties must be created or retained, if they do not otherwise exist.
- Records sufficient to **produce material profit and loss statements** that are relevant for determining the U.S. tax treatment of transactions between the reporting corporation and foreign related parties must be created if such records are not ordinarily maintained.

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All internal records storage and retrieval systems used for each taxable year must be retained.

### ***2. Descriptions Of Categories Of Documents To Be Maintained<sup>26</sup>***

In order to meet the requirements of the safe harbor provisions, the following records must be maintained to the extent they may be relevant to determine the correct tax treatment of transactions between a reporting corporation and any foreign related person or party.

#### **A. Original Entry Books And Transaction Records**

This category includes books and records of original entry or their functional equivalents, however labeled, which are relevant to transactions between any foreign related party and the reporting corporation.

Examples:

- General Ledgers
- Sales Journals
- Purchase Order Books
- Cash Receipts Books
- Cash Disbursement Books
- Canceled Checks and Bank Statements
- Workpapers
- Sales Contracts
- Purchase Invoices
- Chart of Accounts
- Accounting Policy Manual

#### **B. Profit And Loss Statements**

This category includes records from which the reporting corporation can compile and supply, within a reasonable time, **material profit and loss statements** of the reporting corporation and **all** "related parties" that reflect profit or loss of the

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related party group attributable to **U.S.-connected products or services**. **U.S.-connected products or services** means products or services that are imported to or exported from the U.S. by transfers between the reporting corporation and any of its foreign related parties.<sup>27</sup>

See Treas. Reg. §1.6038A(c)(2)(ii) for the information that the profit and loss statements should contain. A profit and loss statement will be **material** if it meets any of the following tests:

- The existing records test,<sup>28</sup>
- The significant industry segment test,<sup>29</sup>
- The high profits test,<sup>30</sup> and
- The return on assets test<sup>31</sup>

See Treas. Reg. §1.6038A-3(c) for detailed information about these tests.

### C. Pricing Documents<sup>32</sup>

This category includes all documents relevant to establishing the appropriate price or rate for transactions between the reporting corporation and any foreign related person or party.

Examples include (but are not limited to):

- Documents related to transactions involving the same or similar products or services entered into by the reporting corporation or a foreign related party with related and unrelated parties,
- Shipping and export documents,
- Commission agreements,
- Documents relating to production or assembly facilities,
- Third party and intercompany purchases invoices,
- Manuals, specifications, and similar documents relating to or describing the performance of functions conducted at particular location,
- Intercompany correspondence discussing any instructions or assistance relating to such transactions provided to the reporting corporations by the related foreign person (or vice versa),

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- Intercompany and intracompany correspondence concerning the price or the negotiation of the price used in such transactions,
  - Documents related to the value and ownership of intangibles used or developed by the reporting corporation or the foreign related party,
  - Documents related to cost of goods sold and other expenses, and
  - Documents related to direct and indirect selling, and general and administrative expenses (example: related to advertising, sales promotions, or warranties).

### **D. Foreign Country And 3rd-Party Filings<sup>33</sup>**

This category includes financial and other documents relevant to transactions between a reporting corporation and any foreign related party filed with or prepared for:

- any foreign government entity,
- any independent commission, or
- any financial institution.

### **E. Ownership And Capital Structure Records<sup>34</sup>**

This category includes records or charts showing:

- The relationship between the reporting corporation and the foreign related party,
- The location, ownership, and status (example: joint venture, partnership, branch, or division) of all entities and offices directly or indirectly involved in the transactions between the reporting corporation and any foreign related party,
- A worldwide organization chart,
- Records showing the management structure of all foreign affiliates, and
- Loan documents, agreements and other documents relating to any transfer of stock of the reporting corporation that results in the change of the status of a foreign person as a foreign related party.

### **F. Records Of Loans, Services, And Other Non-Sales Transactions<sup>35</sup>**

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This category includes relevant documents relating to:

- \* Loans (including all deposits by one foreign related party or reporting corporation with an unrelated party and a subsequent loan by that unrelated party to a foreign related party or reporting corporation and a foreign related party),
- \* Guarantees of a foreign related party of debts of the reporting corporation, and vice versa,
- \* Hedging, other risk shifting, or currency risk shifting arrangements involving the reporting corporation and any foreign related party,
- \* Security agreements between the reporting corporation and any foreign related party,
- \* Research and development expense allocations between any foreign related party and the reporting corporation,
- \* Service transactions between any foreign related party and the reporting corporation, including:
  - a description of the allocation of charges for management services
  - time or travel records
  - Allocation studies,
- \* Import and export transactions between a reporting corporation and any foreign related party,
- \* The registration of patents and copyrights with respect to transactions between the reporting corporation and any foreign related party, and
- \* Documents regarding lawsuits in foreign countries that relate to such transactions between a reporting corporation and any foreign related party (e.g. product liability suits for U.S. products).

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### **G. Liability For Partnership Record Maintenance<sup>36</sup>**

A reporting corporation, whose interest in the capital or profits of the partnership, either directly or indirectly, combined with the interests of all related parties of the reporting corporation partner, equal 25% or more of the total partnership interests, is subject to the record maintenance requirements to the extent of the transactions attributed to it by the domestic or foreign partnership.

Attribution of transactions shall be made only to the extent of the partnership interest held by the reporting corporation partner unless the transactions occur directly between the partnership and a reporting corporation, then no attribution will be made.<sup>37</sup>

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### ***f. Location Of Records<sup>38</sup>***

As a general rule, records must be maintained in the U.S.

Records may be maintained outside the U.S., if the records are not ordinarily maintained in the U.S. and, upon request, the reporting corporation delivers the records to the IRS, or moves them to the U.S. and provides an index to the IRS, within 60 days of the request.

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### ***g. California's Monetary Penalty***

#### ***1. Imposition Of The Monetary Penalty<sup>39</sup>***

##### ***A. Form 5471***

A penalty of \$1,000 is imposed for each income year that the taxpayer fails to timely file a required Form 5471. The penalty is imposed for each information return (Form 5471) not filed. Therefore, if a taxpayer fails to file 20 forms in any given year, the taxpayer will be assessed \$20,000.

An additional \$1,000 penalty is charged for each 30-day period or fraction thereof, during which failure continues after the 90-day period has expired. The maximum amount of the additional penalty for each failure is \$24,000.

The penalty imposed will not apply to returns required to be filed for income years beginning before January 1, 1998. The same penalty will be imposed with regard to Form 8865 for foreign partnerships. However, the filing requirement for Forms 8865 was not generally effective before 2000, and the effective date varies depending upon the taxpayer's circumstances. See the instructions to the Federal Form 8865 for more information regarding the effective date for the Form 8865 filing requirement.

##### **Exceptions:**

The penalty will not be imposed if the failure to file the Form 5471 was due to reasonable cause and not due to willful neglect (§19141.2(c)(1)). Furthermore, the penalty will not be imposed if the Form 5471 or Form 8865 was not attached to the taxpayer's return but the taxpayer does both of the following:

- A. furnishes a copy of the form either upon the taxpayer's initiative or within 90 days of notification by the Franchise Tax Board, and
- B. agrees to attach a copy of the form on the original return filed for the subsequent income years.

The Franchise Tax Board may waive all or any portion of the penalty imposed when the taxpayer has entered into a voluntary disclosure agreement.



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**Note:** FTB's authority to waive penalties under §21015 does **not** apply to the §19141.2 Penalty for Failure to File Form 5471.

### ***B. Form 5472***

- A. A penalty of **\$10,000** per taxpayer will be assessed for each income year that the taxpayer fails to timely file a substantially complete 5472. This penalty is imposed on a **per form** basis, thus if the taxpayer has a requirement to file 20 Form 5472s in any given year, their penalty would be \$200,000 (\$10,000 x 20).
- B. A penalty of \$10,000 is also assessed for failing to maintain the records required by §1.6038A-3 (Chapter 20A(e), Water's-Edge Manual **and** Chapter 20A(f) Water's-Edge Manual above), or in the case of records maintained outside the US, failing to meet the non-US record maintenance requirements within the applicable time prescribed in 1§6038A-3(f). This penalty is not based on an item-by-item determination. A failure to maintain a single or small number of items may not constitute a failure unless the item(s) is essential for the correct determination of transactions between the reporting corporation and any foreign related parties.
- C. An **additional \$10,000** penalty will be assessed if the taxpayer fails to file a form 5472 or fails to comply with the record maintenance requirement within 90 days of notification by FTB.<sup>40</sup>
  - The additional penalty is for each 30-day period, or fraction thereof, past the 90-day period. There is no maximum penalty cap.
  - The taxpayer has no protest or appeal rights. The penalty is imposed as a supplemental assessment. The supplemental assessment must be paid before the taxpayer can file a Claim for Refund. (Per §19041, a taxpayer can protest a notice of proposed deficiency assessment. A deficiency assessment is defined as an assessment of additional tax (§19043). The protest provisions of §19041 do not apply to penalties.)

If at any time subsequent to the first imposition of the monetary penalty (such as failure to file a timely Form 5472), a second failure (such as failure to maintain records) is determined and the second failure continues after notification, an additional penalty may be assessed.

The additional penalty will **cease to accrue** if the reporting corporation:

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- files Form 5472;
  - furnished information to substantially complete Form 5472;
  - demonstrates compliance with respect to the maintenance of records; or
  - produces or moves to the U.S. information, documents or records kept outside the U.S.

### **2. Reasonable Cause<sup>41</sup>**

The taxpayer should be provided an opportunity to establish reasonable cause for their failure to timely file Form 5471 or 5472 with the Franchise Tax Board before the supplemental assessment is issued. Normal reasonable cause provisions apply.

See [Exhibit 20A-1](#) for a sample of a letter to send to taxpayers to inform them of our intent to assess a penalty and the reasonable cause exception. It is department policy to provide the taxpayer the opportunity to establish that reasonable cause is present before imposing the penalty.

### **3. Reasonable Cause For Small Corporations**

Reasonable cause for failing to file a Form 5472 is to be liberally interpreted for small corporations.<sup>42</sup> A small corporation for purposes of applying the penalty provisions is defined as a corporation whose gross receipts are \$20,000,000 or less for a taxable year, AND:

1. had no knowledge of the requirements imposed by IRC §6038A,
2. has a limited presence in and contact with the U.S., and
3. promptly and fully complies with all requests to file Form(s) 5472 and/or to furnish books, records, or other materials relevant to the reportable transaction.

### **4. Effective Dates<sup>43</sup>**

#### **a. Form 5471**

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The California penalty for failure to file Form 5471 applies to years beginning on or after January 1, 1998.

### **b. Form 5472**

The California monetary penalty for failure to file Form 5472 applies to years beginning on or after January 1, 1990. (The California penalty is the same as the federal penalty.)

The federal and California monetary penalty for failure to maintain records or the failure to produce documents is effective December 10, 1990, without regard to the taxable year to which the records relate.

### **5. No Harm To The State (FTB) Exception**

Revenue and Taxation Code Section 21015 was enacted in October 1995 and applies to penalties under §19141.5 (failure to file Form 5472) that are assessed or imposed on or after January 1, 1995. This section provides that the board may either refrain from imposing or waive the penalties described above where it is determined that the failure to comply did not jeopardize the best interests of the state and is not due to any willful neglect or any intent not to comply. It is the auditor's responsibility to consider whether §21015 will apply to a penalty. If §21015 would apply under the taxpayer's circumstances, the auditor should recommend not imposing the penalty regardless of whether the taxpayer has specifically requested relief under §21015.

In Legal Ruling 96-3, situation #3, the taxpayer did not submit the required Forms 5472 until they were requested during the FTB audit. Because the 5472s were needed for the audit selection process and were not available at that time, the Legal Ruling indicates that the best interests of the state were jeopardized. Therefore, the penalty was not waived.

As a general rule, the penalty should not be waived under R&TC §21015 if the Forms 5472 were not present during the scoping of the returns and this impeded the auditor's ability to effectively determine the audit potential of the returns. On the other hand, there have been cases where the best interests of the state were not jeopardized by the failure to attach the Forms 5472 because those forms

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were not needed during the scope of the returns. For example, in a worldwide combined report, the primary use of the 5472s is to determine the magnitude of intercompany transactions between the domestic and foreign affiliates in order to evaluate unitary issues. If a test check using annual report information from Lexis-Nexis indicates that there would be no tax effect from pursuing any unitary issues, then an evaluation of the strength of the unitary issues is generally not necessary. Therefore, there may not be a need for the 5472s. In a water's-edge combined report the 5472s are helpful for identifying a variety of issues, so it is more likely that the audit selection process will be impeded if the 5472s are not available. However, the auditor's recommendation regarding whether the penalty should be waived under §21015 should still address whether the 5472s were actually used in the audit or scoping process.

**Note:** FTB's authority to waive penalties under §21015 only applies to the §19141.5 penalty for failure to file Form 5472. It does **not** apply to the §19141.2 penalty for failure to file Form 5471.

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### ***h. Authorization Of Agent<sup>44</sup>***

Upon request by the IRS/FTB, a foreign related party will authorize as its limited agent (solely for purposes of powers of examination) the reporting corporation with which it engages in transactions. The request would be for the purpose of examining records or producing testimony that may be relevant to the tax treatment of such transactions or with respect to any summons by the IRS (subpoena duces tecum for FTB) for such records or testimony. A single authorization may be made on a consolidated basis by a corporation that has effective legal authority to act as agent for members of a foreign affiliated group.

The noncompliance penalty (Chapter 20A(j), Water's-Edge Manual) shall apply if:

- the foreign related party fails to authorize the reporting corporation as its agent; or
- in circumstances where a consolidated authorization of agent has been executed, but the agency authorization for any members of the group is determined not to be legally effective for purposes of the powers of examination.

In exceptional circumstances the reporting corporation may be deemed to be an authorized agent in cases where the foreign related party fails to authorize the reporting corporation to be its agent.<sup>45</sup>

The authorization of agent requirement is effective December 10, 1990 without regard to when the taxable year to which the records relate began.<sup>46</sup>

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### *i. Subpoena Duces Tecum*

#### **1. Failure To Comply With A Subpoena Duces Tecum<sup>47</sup>**

For Federal/California purposes, the noncompliance penalty will apply if a summons/subpoena duces tecum is issued to the reporting corporation to produce any records either directly or as an agent for a foreign related party, to determine the correct treatment of the transaction and if:

- the summons/subpoena is **not** quashed or determined to be invalid, and
- the reporting corporation does not substantially and timely comply with the summons/subpoena and the FTB has sent by certified or registered mail a notice to the reporting corporation that it has not complied, or
- the reporting corporation fails to maintain or to cause another to maintain records and by reason of that failure, the summons/subpoena duces tecum is quashed or the reporting corporation is not able to provide the records requested in the summons/subpoena.

The petition to quash is the only means of preventing the application of the noncompliance penalty. A legal proceeding to enforce the subpoena (or summons) is not required in order to apply the noncompliance penalty.<sup>48</sup>

#### **2. Jurisdiction<sup>49</sup>**

The courts have jurisdiction to hear the motion to quash the subpoena and/or review the noncompliance determination described in this section.

#### **3. Statute Of Limitations**

The statute of limitations is suspended during the judicial proceeding.

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### **4. *Effective Date*** <sup>50</sup>

Rules for failure to furnish information under a summons (federal) or subpoena (California) are effective November 6, 1990 without regard to the taxable year to which the summons/subpoena relates began.

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### ***j. Noncompliance Penalty Adjustment<sup>51</sup>***

Any reporting corporation's failure to:

- obtain an authorization from its foreign related parties to act as their agent (Chapter 20A(h), Water's-Edge Manual), or
- furnish information pursuant to an FTB subpoena duces tecum (summons for IRS) (Chapter 20A(i), Water's-Edge Manual)

will result in the application of the noncompliance penalty to the reporting corporation.

**NOTE:** This penalty is not a true penalty. This provision gives the IRS/FTB the authority to penalize the taxpayer by adjusting related party transactions either by disallowing deductions or reducing basis of assets sold or exchanged.

#### ***1. Noncompliance Penalty***

In the case of any failure to authorize an agent or furnish information pursuant to a subpoena, the

- amounts allowed as a deduction for amounts paid or incurred to the related party, and
- amounts allowed for the cost of any property purchased from the foreign related party or sold by the reporting corporation to the foreign related party

will be determined by IRS/FTB in its sole discretion based upon information that IRS/FTB may choose to obtain. (The federal Conference Committee Report made it very clear that they intended the IRS determination to be given more weight than the current abuse of discretion rules under IRC §482.)



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### ***2. Effective Date<sup>52</sup>***

The noncompliance penalty adjustment is effective December 10, 1990 for federal and California tax purposes without regard to the taxable year to which the records relate.

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### ***k. Audit Procedures***

#### **Form 5471**

- \* Review the federal consolidated return
- \* If Forms 5471 were filed for federal purposes, determine whether they should also be filed for state purposes. The forms will only be required for California purposes if the reporting corporation is a California taxpayer. The 5471 forms are required to be filed for income years beginning January 1, 1997 but the penalty will not be imposed for years beginning prior to January 1, 1998.
- \* Identify foreign affiliates
  - Determine whether any taxpayer corporations in the combined report own more than 50% of the foreign affiliate.
  - Determine whether any taxpayer corporations in the combined report own 10% or more of a foreign affiliate that is a controlled foreign corporation.

#### **Form 5472**

- \* Identify foreign ownership
  - Is the reporting corporation owned more than 25% by foreign entity?
  - Is the reporting corporation a foreign corporation engaged in a trade or business within the U.S.?
- \* Identify reportable transactions. Remember, if there are no reportable transactions with foreign affiliates, there is no filing requirement.
- \* If the reporting entity (California taxpayers only) is included in federal consolidated Form 5472 filings, obtain a copy of the spreadsheet for each consolidated form showing the breakdown by entity of the transactions with the related party. From the breakdown, the auditor should be able to tell if the reporting corporation had transactions with the related party. This will show how many Form 5472's were required to be filed per entity.
- \* Review taxpayer's copy of Federal Form 1120 to identify the number of forms filed by taxpayer corporations with IRS.

#### **Were Forms 5471 and 5472 timely filed?**

Forms 5471 and 5472 are required to be filed by the due date or extended due date of the return. With regard to the Form 5472, did the taxpayer file a timely amended return during the amnesty period? Also, remember that Forms 5472

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were not generally required for income years beginning before 1/1/91 for financial corporations.

For state purposes, the Form 5471 must be filed beginning on or after January 1, 1997 but the penalty is not imposed for income years beginning prior to January 1, 1998.

**If required Forms 5471 or 5472 were not filed:**

Obtain copies from the taxpayer of all Form 5471s and 5472s that were not timely filed. The auditor should evaluate whether or not the penalties should be assessed. The penalty should not be assessed in those cases where the taxpayer can show it acted in good faith and reasonable cause is present. The taxpayer should be made aware of the reasonable cause and good faith exception and requested to explain in writing if they believe that reasonable cause is present. With regard to the Form 5472, the penalty may not be imposed in cases where there is no harm to the FTB.

If the taxpayer is uncooperative, obtain copies of Forms 5471 and 5472 from IRS.

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### *I. Summary*

#### IRC §6038

California's conformity to IRC §6038 provides an information reporting requirement for taxpayer corporations that own more than 50% of a foreign corporation or 10% or more of a controlled foreign corporation.

IRC §6038 addresses the following:

- Requirement of federal Form 5471
- The failure to file penalty

#### IRC §6038A

California's conformity to IRC §6038A provides information reporting requirements for entities which are more than 25% foreign-owned or foreign entities which are engaged in a trade or business in the U.S.

IRC §6038A addresses the following:

- Requirement of federal Form 5472
- Record Maintenance
- Monetary Penalty for failure to furnish information or maintain records
- Authorization of Agent
- Enforcement Proceedings
- Noncompliance and its related penalty

ALL taxpayers, not just taxpayers filing on a water's-edge basis, are subject to the provisions of IRC §6038 and §6038A.

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### **Footnotes**

1. IRC §6038A(a)
2. IRC §6038C(a)
3. Treas. Reg. §1.6038A-1(c)(5)
4. IRC §6038A(c)(2); Treas. Reg. §1.6038A-1(d)
5. IRC §6038A(c)(1)
6. IRC §6038A(c)(5)
7. Treas. Reg. 1.6038A-1(f)
8. Treas. Reg. §1.6038A-2(a)(2)
9. Treas. Reg. 1.6038A-2(a)(1)
10. Treas. Reg. 1.6038A-2(b)(6)(i)
11. Treas. Reg. §1.6038A-2(b)(7)
12. Treas. Reg. §1.6038A-2(f)(1)
13. Treas. Reg. §1.6038A-2(f)(3)
14. Treas. Reg. §1.6038A-2(f)(4)
15. Treas. Reg. 1.6038A-1(k)
16. Treas. Reg. §1.6038A-2(d)
17. Treas. Reg. §1.6038A-1(n)(2)
18. Treas. Reg. §1.6038A-3
19. Treas. Reg. 1.6038A-3(a)
20. Treas. Reg. §1.6038A-1(h)
21. Treas. Reg. §1.6038A-3(b)(3)
22. Treas. Reg. §1.6038A-1(n)(3)
23. Treas. Reg. §1.6038A-3(f)
24. Treas. Reg. §1.6038A-3(c)
25. Treas. Reg. 1.6038A-3(c)(1)
26. Treas. Reg. 1.6038A-3(c)(2)
27. Treas. Reg. 1.6038A-3(c)(7)
28. Treas. Reg. §1.6038A-3(c)(4)
29. Treas. Reg. 1.6038A-3(c)(5)
30. Treas. Reg. §1.6038A-3(c)(6)
31. Treas. Reg. §1.6038A-3(c)(6)(ii)
32. Treas. Reg. §1.6038A-3(c)(2)(iii)
33. Treas. Reg. §1.6038A-3(c)(2)(iv)
34. Treas. Reg. §1.6038A-3(c)(2)(v)
35. Treas. Reg. §1.6038A-3(c)(2)(vi)
36. Treas. Reg. §1.6038A-3(d)
37. Treas. Reg. §1.6038A-1(e)(2)

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38. Treas. Reg. §1.6038A-3(f)
  39. Treas. Reg. §1.6038A-4
  40. Treas. Reg. §1.6038A-4(d)
  41. Treas. Reg. 1.6038A-4(b)
  42. Treas. Reg. §1.6038A-4(b)(2)(ii)
  43. Treas. Reg. §1.6038A-1(n)(4)
  44. Treas. Reg. §1.6038A-5
  45. Treas. Reg. §1.6038A-5(f)
  46. Treas. Reg. §1.6038A-1(n)(5)
  47. Treas. Reg. §1.6038A-6 as modified by R&TC §19141.5(a)(4)(B)
  48. Treas. Reg. §1.6038A-6(c)
  49. IRC §6038A(e)(4)(C) modified by R&TC §19141.5(a)(4)(C)
  50. Treas. Reg. §1.6038A-1(n)(6)
  51. Treas. Reg. §1.6038A-7
  52. Treas. Reg. §1.6038A-7(d)